



Testimony of Rob Fowler
President and CEO, Small Business Association of Michigan
Joint Committee of House and Senate Tax Policy
April 25, 2005

Thank you Madame Chair and Mr. Chairman and members of the joint Committee of the House and Senate Tax Committees. My name is Rob Fowler and I serve as the President and CEO of the Small Business Association of Michigan. Thank you for the opportunity to come before you today and share the perspective of small businesses on the issue of business tax policy generally and specifically to respond to the proposal put forth by the Governor, the Michigan Jobs and Investment Act.

There has apparently been some confusion as to where we stand on this issue. My hope is to clarify and explain our position and perhaps more importantly to explain how we would like to see this debate evolve. We support portions of the Governor's proposal and we don't support portions of the Governor's proposal. We neither support nor oppose the entire package as it sits before you at this moment. This is why we have said from the beginning that the Governor has started an important debate with some very strong concepts which we support. We recognize that we are at the very beginning of this process and that much will change along the way, but it's a great start. I will elaborate on specifically which parts we support, what we would like to see included in the proposal, and what we don't support.

Background

I know that you don't need to hear one more time that Michigan currently has the nation's highest unemployment rate or that we are last to recover economically. I know that you don't need to be reminded that we are the state with the distinction of having lost the most manufacturing jobs. However, this is the backdrop against which this discussion will take place. I would add one further dose of perspective, perhaps even more sobering

to our long term economic prospects as a state. That is, 'how are we doing from the perspective of growing entrepreneurs?'

Some of you know that, through our foundation, we recently released the Michigan Entrepreneurship Scorecard in which we were able to compare Michigan to the other 49 states on over 100 measures. This is a one-of-a-kind study in the country because it compares states on the issues relating to entrepreneurship. One key indicator is the Issue of Entrepreneurial Dynamism.

Entrepreneurial Dynamism is the measure of how we are doing currently in five areas; small business growth, "churn rate" (new business start-ups minus failures), small business payroll growth, number of fast growing new businesses, and non-wage income growth. On this important indicator, Michigan receives an "F". As a state, we must move forward on many different fronts to change this.

We cannot hope to be one of this country's most entrepreneurial states without a competitive business tax climate, a tax climate that rewards risk and investment, a tax climate that does not punish job creation, a tax climate that recognizes the burden that government places on an early stage business, a tax climate that does not form a millstone around the necks of new businesses.

What we like about this proposal

There are four concepts in the Governor's proposal that we support.

The first is the tax cut. The main concept of this entire package is business tax relief as a strategy for economic recovery. We support that. We expect that there will be plenty of discussion on how to accomplish this business tax cut. But at the outset, we hope there can be agreement that this is urgently necessary. A proposal this complex has lots of moving parts which leaves endless opportunities for negotiation. Our goal is to get to the end of this debate with meaningful tax relief for businesses.

Second is the concept that Corporate Profits should be the primary basis for business taxation. It is important to keep in mind that, non-corporations (i.e. S-corps, LLCs, Sole-Proprietorships, etc.) are "pass-through" entities. Which means that profits are taxed at the business through the current SBT and the business owner pays the Michigan Individual Income tax on profits they take home. This issue of double taxation has long concerned us and as a result, we have been a proponent of eliminating taxes on non-corporations. This proposal moves in this direction.

I think it is also important to recognize on this topic that triple weighting of profits and lowering the rate has the effect of moving our tax system away from its current emphasis on taxing payroll and investment (i.e. machinery and equipment). One of the biggest criticisms of the Michigan SBT is that it taxes a business for the "privilege" of doing business in Michigan whether or not the business is profitable. Profitability is a better indication of a businesses' ability to pay the tax and is therefore less onerous.

The third part of the Governor's proposal that we support is the focus on Research and Development. Both through the proposed property tax credit and through a separate R&D credit, this proposal recognizes the importance of developing future businesses. We believe that it is critically important for Michigan to take advantage of a strategic

advantage that we have and that we are currently failing to capitalize on. Michigan ranks number one in the nation in Private Sector R&D, and number four in University R&D dollars. Yet, by several measures, we are failing to commercialize at a rate that is worthy of our capacity.

In a study released last week by the US Small Business Administration entitled *The Innovation-Entrepreneurship Nexus*, the primary finding is that “innovation without entrepreneurship yields minimal economic benefit”. In other words, its interesting that we are number one in Private Sector R&D and number four in University R&D dollars, but unless there are entrepreneurs in place with the proper incentives to pull that innovation off the shelf, we will not realize the potential we have as a state. Other states with a fraction of our potential have been more aggressive in this area. We can do better.

Fourth is the recognition that property taxes are a part of the equation and when taken into consideration, make us less competitive as a state. The proposed credit against the SBT for property taxes paid, even with its limitations to manufacturing and R&D activities, recognizes that property taxes are a problem for locating and growing a business here. It is at least a clever approach that does not take the revenue from the local government. At most, this could be groundbreaking in terms of the way we think about the relationship between state and local business taxes. This concept deserves your serious consideration.

What we want to see added

There are four issues that we think should be included before we get tot the finish line with this legislation:

The first is the so-called “Health Care Add-back”. We have long believed that it makes no public policy sense to tax employers for providing benefits to their employees. We started last year to remove the value of health insurance from the calculation of the tax base for SBT. We should finish the job.

Next, we believe that if there is going to be a premium tax on insurers that all providers of health insurance should be exempt. The proposal currently exempts BCBSM, all HMO’s and self-insured plans. It should treat all health insurance providers equally.

The third issue that we believe should be included is a Transferable R&D credit. The issue of transferability is key. An entrepreneur who qualifies for the credit but is either too small or does not have sufficient tax liability to utilize the credit loses the value of the credit. If it were transferable, it would become a part of the value of the company and could be used to attract capital and/or strategic partners who could help grow the company.

And fourth, to eliminate the eligibility criteria of the Alternative Profits Tax (ATP) so that all small businesses may choose this tax as an alternative to the SBT. Contained within the SBT is the Alternative Profits Tax. Available to qualifying small businesses, it is a 2% profit tax on adjusted business income. Currently, criteria prevent many small businesses from qualifying for the alternative. There are currently three qualifying criteria: 1) no one owner can make more than \$115,000. 2) Company sales are \$10 million or less and, 3) Adjusted business income is \$475,000 or less. SBAM supports eliminating the criteria so that all small businesses have the option of choosing the regular SBT or the Alternative Profits Tax.

As a matter of priority, we believe owner's income is the most limiting criteria that prevent a small business from qualifying for the ATP option. We propose eliminating the owner's income criteria completely and then take a look at adjusting the other criteria upward as much as possible.

Not our Issue

We do not support a premium tax on insurance companies. We also do not have a position that would allow us to oppose such a tax. This issue has historically not been one that we have waded in on since we have no insurance providers as members. Our tax principles are silent on such a tax and our historical policy positions are silent on this issue. Said differently, if we can find another way to offset this tax cut, we are not wedded to the premium tax increase.

The second aspect of the Governor's plan that is not our issue is "revenue neutrality." We do not believe that it should be a key feature of tax reform. We acknowledge that Michigan must balance its budget each year. However, consistent with our SBAM- Tax Reform Principles, we believe that with tax reform we should consider the overall tax burden on Michigan businesses. Furthermore, reform must encourage the growth of the small business economy. Therefore, in context of the overall state budget, cuts in government spending should be implemented before offsetting tax increases are considered. Many studies have shown that Michigan has an unacceptably high business tax burden. We can and should do better.

Conclusion

Much of the discussion to date on the Governor's proposal has been on the issue of "winners and losers". I think it's important to acknowledge that tax policy always picks winners and losers – it's the nature of the business of tax policy. Every time you pass a tax credit or make any change to current tax policy you are picking winners or losers. In fact, we need to recognize that our current tax law already rewards some businesses and punishes others.

We believe that we need to lift our sights from a discussion about "winners and losers" and begin to discuss positioning Michigan to compete for and create the jobs and the businesses of the future. A strong and vibrant economy is the medicine that most small businesses need today. Let's create a competitive business climate that makes winners of all Michigan businesses. Because, today we are all losing.

SBAM Principles for Michigan Business Tax Reform

1. Any potential tax reform proposals should consider the overall tax burden and how the interaction of federal and local taxes affects Michigan businesses.
2. Any potential tax reform must encourage growth of the small business economy.
3. Taxes should be imposed on an individual or business entity only once.
4. SBAM opposes expanding the state sales tax to include services until such time as our nation replaces the federal income tax with a national sales tax.
5. Business to business transactions should be exempt from taxation.
6. The tax system must avoid imposing an undue tax burden on growing small businesses and not unduly hinder their ability to create jobs and economic prosperity.
7. An appropriate, phased-in threshold should be established before a business is taxed or a credit is allowed or disallowed. The state should avoid tax "cliffs" that encourage businesses to intentionally suppress profits or business activity in order to escape an increased tax obligation.
8. Any replacement or reform of Michigan business taxes should be deferred until government spending is reduced and fiscal solvency established.
9. Michigan's overall tax burden should be less than the tax burden in the states with which we compete. To that end, the state of Michigan should commission a comparative benchmarking analysis of various state tax systems.
10. The appropriate basis for taxation is profits. Taxation based on business profits rather than business activity will have greater revenue fluctuations from year to year. Recognizing the need for the State to stabilize available revenue, a solid financial formula should be established for diverting surplus money into the Michigan Budget Stabilization Fund during economic expansions to provide for appropriate withdrawals during economic downturns. To insure the long-term solvency of the Michigan Budget Stabilization Fund, the State of Michigan should establish a constitutional amendment or supermajority (2/3) vote to provide greater protection from unwarranted raids by the legislature.
11. Repeal of the SBT should occur in 2009 or before. Until that time the statutory schedule for reducing the SBT rate should be unfrozen and allowed to continue.
12. The business taxation system should be predictable to allow for advance planning of tax expenses.